

# Issues Affecting Unit-linked Insurance Business

February 2019



## Overview

In the UK, unit-linked insurance makes up the largest proportion of the life insurance market. According to the latest set of Solvency and Financial Condition Reports (“**SFCRs**”), in 2017, 60% of the technical provisions (equating to approximately £1.1 trillion) and 69% of the gross written premiums for UK life insurers related to unit-linked business. Approximately 11% of all unit-linked business in the UK is reinsured, equivalent to approximately £127 billion or 66% of all reinsurance in the UK life insurance market.

This paper summarises a number of the most material developments affecting unit-linked insurance business that occurred during 2018 and which remain areas of ongoing focus.

## The FCA Asset Management Market Study

On 28 June 2017, the Financial Conduct Authority (“**FCA**”) published a report setting out the final findings of its Asset Management Market Study (“**AMMS**”), which includes proposals to drive competitive pressure on asset managers, increase value for money for investors and improve the effectiveness of intermediaries. Alongside this report, the FCA published a consultation paper for the first set of proposed remedies, which focus on the duties of fund managers as the agents of investors in their funds, and asked for stakeholders’ views on whether its governance proposals for fund managers should be extended to unit-linked and with-profits insurance products. In September 2017, Milliman produced a summary<sup>1</sup> highlighting the key outcomes of the FCA’s AMMS report alongside our own views on the potential implications for UK life insurers.

The FCA received mixed feedback from industry participants as to whether it should extend its governance proposals to unit-linked and with-profits insurance products.

- The Institute and Faculty of Actuaries, for example, disagreed that unit-linked and with-profits insurance products have weaker governance relative to the FCA’s proposals. It pointed out that value for money is already actively assessed for these products in a way that is appropriate to their unique charging structure, and recommended that the governance arrangements for these products be considered holistically rather than extending a

requirement designed for business with different characteristics.

- By contrast, the Financial Services Consumer Panel expressed the view that consumers invested in unit-linked or with-profits insurance products would benefit from the increased protections expected to be delivered by the FCA’s governance proposals, and warned of the potential for regulatory arbitrage should the proposals not be extended to these products.

A policy statement<sup>2</sup> for the first set of AMMS remedies and a consultation paper for the second set of proposed remedies were released on 5 April 2018. Most recently, the FCA published a policy statement<sup>3</sup> on 4 February 2019 with final rules and guidance for the second set of remedies, which do not significantly differ from the proposals on which the FCA consulted. In particular, they focus on the information fund managers should provide to investors on:

- Fund objectives and investment policies; and
- Benchmarks and performance.

Although the FCA has not extended its proposals to unit-linked and with-profits insurance products at this time, it is currently undertaking diagnostic work to assess any harm that exists in these markets and expects to reach a view on whether further intervention is required later in 2019.

For unit-linked business specifically, a review focusing on the strength of oversight and the value for money of different products is underway, involving a number of firms of different size across the industry, including asset managers, life insurance subsidiaries of assets managers, mutual insurers and large diversified funds. At this time it is difficult to predict what the outcome of this diagnostic work will be but, at a minimum, some form of FCA guidance or recommendations on governance for unit-linked business seems likely. It is therefore important that unit-linked providers continue to monitor developments in the AMMS space and review their fund governance arrangements to identify potential gaps relative to market best practice and the FCA’s expectations.

## EIOPA’s Q&A on regulation

Throughout 2018, the European Insurance and Occupational Pensions Authority (“**EIOPA**”) released new sets of questions and answers on regulation<sup>4</sup>. In particular, in November, there

<sup>1</sup> Please contact us if you would like to receive a copy of this summary.

<sup>2</sup> [PS18/8: Implementing asset management market study remedies and changes to our Handbook](#)

<sup>3</sup> [PS19/4: Asset Management Market Study – feedback to CP18/9 and final rules and guidance](#)

<sup>4</sup> <https://eiopa.europa.eu/Pages/Guidelines/Q-and-A-on-Regulation-Answers-Delegated-Regulation.aspx>

were two questions that EIOPA answered which shed light on the treatment of expenses within the Mass Lapse and Operational Risk modules of the Standard Formula SCR calculation.

#### THE TREATMENT OF EXPENSES IN THE MASS LAPSE STRESS

Question 1678 asked: “*When calculating the capital requirement for Mass Lapse risk should the per-policy expenses remain unchanged, resulting in the overall expenses falling proportionally?*” Until now, insurers may have been of the view that per policy expenses could be assumed to remain unchanged following the Mass Lapse stress, and external auditors may have advocated this view. However, EIOPA’s response to this question clarified that it would expect insurers to consider whether it is realistic to assume that their expenses would reduce proportionally following a Mass Lapse event or if it is more appropriate to assume some level of increase in per policy expenses.

There is arguably some contradiction or inconsistency in EIOPA’s response versus aspects of the Level 1 Directive and Level 2 Delegated Regulation, which has led to a degree of uncertainty amongst insurers and the need for careful interpretation. For example:

- Some firms interpret the market consistency construct of the Pillar 1 requirements as meaning that own company expenses are not directly relevant in both the calculation of the technical provisions and the SCR; and
- The idea of a per policy expense is really just a construct for expense allocation and there is no default position that a company will model its expenses globally using an underlying per policy cost allowance. The thrust of EIOPA’s statement is more about the nature of expenses at an aggregate level, i.e. the divide between variable and fixed. We have also seen insurers put in place prior Board-approved management action plans to specify the downwards management of aggregate costs following a Mass Lapse event.

#### THE TREATMENT OF COMMISSION IN THE OPERATIONAL RISK MODULE

Question 1729 asked for clarification as to whether fund-related commission to distributors should be included or excluded in the calculation of the capital requirement for Operational Risk. EIOPA’s response was that commission to the salesforce should be included. This guidance will be of interest to companies that have excluded fund-related commission from the expenses up until now and may therefore need to recalibrate their Operational Risk capital calculations.

<sup>5</sup> See recital 67 of the [Delegated Regulation](#)

Milliman does not certify the information in this paper, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.

However, the recitals to the Delegated Regulation conflict with this response in suggesting that all forms of commission are acquisition costs and therefore not in scope of the Operational Risk SCR calculation<sup>5</sup>. We have also seen some insurers make the argument that EIOPA’s Q&A specifically refers to own agents’ commission and they have interpreted this as excluding IFA remuneration, for example.

## Solvency II unit matching

In July 2018, Milliman and P Turnbull Financial Management published a white paper on the benefits of Solvency II unit matching<sup>6</sup> which, at a high level, is the process of only holding units to cover the unit-linked part of the technical provisions (plus an appropriate ‘buffer’).

Unit matching is not a new idea. In 2015, Milliman published an initial paper on unit matching; however, since that time, insurers have started to look for ways to optimise their capital positions under Solvency II and we increasingly see firms considering one-off changes and longer-term strategies to optimise their balance sheets – one such strategy being unit matching.

Now that the first firms have implemented unit matching, the purpose of our latest paper is to expand on how it can allow insurers with significant blocks of unit-linked business to dramatically increase their liquidity and reduce market risk. When implemented correctly, unit matching can be beneficial to shareholders without any disadvantage to policyholders and, from the experience of UK firms that have already implemented or are in the process of implementing this strategy, neither the practical implementation nor regulatory engagement should typically be barriers to realising the associated benefits.

## Issues relating to transfers of unit-linked business

Milliman principals have acted as the Independent Expert for numerous Part VII transfers of insurance business over the last few years, many of which have involved transfers of blocks of unit-linked business. Through this experience, we have encountered a number of issues and challenges that are worth a specific mention.

#### SPLITTING UNIT-LINKED FUNDS

Where unit-linked funds are shared between transferring and non-transferring policies, the approach to splitting these funds needs to be carefully considered in order to ensure that there is no material adverse effect on policyholders. In particular:

<sup>6</sup> [Milliman research report: The benefits of Solvency II unit matching](#)

- Depending on whether the combined unit-linked fund and the transferring and non-transferring components are expanding or contracting, splitting the fund could result in a change in the pricing basis (from a higher 'offer' basis to a lower 'bid' basis or vice versa), which in turn could affect the value of the underlying unit-linked policies.
- The majority of unit-linked funds should be straightforward to apportion between transferring and non-transferring policies due to the divisibility of the underlying assets. This may not be the case for property funds, however, which (in the absence of a structure that would allow the notional unitisation of directly held properties) may need to be split by allocating individual property assets either wholly to transferring policies or wholly to non-transferring policies. In such cases, it will not be possible to create two new funds with risk and return profiles that are identical to that of the original fund. Furthermore, the difficulty of constructing objective valuations for property assets may present a material risk of mis-valuation in respect of any particular property and hence a risk of an adverse effect on the policies concerned.

#### OPERATIONAL CHANGES

The transferring policies may experience changes to their dealing cycles, i.e. latest times for which transactions can be processed using a given day's prices, as a result of differences between the systems and/or operations of the transferor and transferee. Factors which are important to consider when assessing the impact of these changes on transferring policyholders include:

- The degree to which the dealing cycles have changed;
- Whether the policyholders typically make manual transactions (and therefore are likely to be affected by a delay in processing the transactions); and
- Whether the funds use forward pricing or historical pricing (and therefore the extent to which investors are likely to have decided to transact based on a specific price).

Similarly, the transfer may give rise to changes to the calculation of unit prices and the application of charges, in which case it is important to consider whether any resulting price differences will be systematic in nature or have a material adverse effect on the transferring policyholders' benefits.

#### REINSURED FUNDS

In cases where reinsurance arrangements will allow the transferring policies to remain invested in funds offered by the transferor after the transfer, it is necessary to consider the

<sup>7</sup> A mutual fund is a professionally managed investment fund that pools money from many investors to purchase securities. Units, or shares, in mutual funds can be purchased or redeemed at the current net asset

impact this will have on the protection afforded to policyholders under the Financial Services and Compensation Scheme ("FSCS").

FSCS protection only covers the default of the primary insurer (which will be the transferee after the transfer). Therefore, if the transferring policies are still ultimately invested in the transferor's funds after the transfer, the transferring policyholders will not be eligible for FSCS compensation should the transferor default. In order to ensure that the transferring policyholders are not adversely affected by the transfer, the transferee may be expected to provide the same level of protection that the policies would have otherwise received from FSCS had the transfer not occurred.

#### MUTUAL FUNDS

We have also seen instances where the transferee has wished to keep the transferring policies invested in funds offered by the transferor, rather than having to establish its own equivalent funds, whilst avoiding a reinsurance arrangement due to the capital associated with the counterparty default risk between the transferor and transferee. Therefore, the transferor has restructured the unit-linked funds that the transferring policies are invested in into equivalent mutual funds<sup>7</sup> that are offered by fund managers within the transferor's group.

Restructuring unit-linked funds can lead to additional issues that need to be considered. Even if these activities are not strictly part of the transfer of business, the fact that they are occurring to facilitate the transfer means that they need to be considered by the Independent Expert in order to ensure that there is no material impact on either the non-transferring or transferring policyholders. In particular:

- Mutual funds typically have additional fees, for example trustee or depositary fees and audit fees, in comparison to unit-linked funds offered by life companies. In this case the transferee may be expected to neutralise any additional fees for the transferring policyholders. In addition, if the non-transferring policyholders are also affected by the restructuring, the transferor may also be expected to neutralise any additional fees that the non-transferring policyholders would otherwise have been charged.
- There are some differences between unit-linked funds offered by life companies and mutual funds in terms of asset security. For example, mutual funds are ring-fenced so that all investments are kept separate from the assets of the company that manages the fund. The fund manager must appoint a depositary (or a trustee if the non-life fund is an authorised unit trust) who will be independent from the fund

value (i.e. the total value of the securities in the fund divided by the total shares outstanding).

manager and have a duty to safeguard the assets and oversee the fund manager in key areas such as unit pricing, dealing, portfolio valuation and in the adherence to investment and borrowing power restrictions. In addition, it is common for the fund manager to appoint a custodian (which is an independent company) for the mutual fund who will hold the assets for safekeeping and be responsible for executing trades and settlements. Overall, policyholders can benefit from increased protection from being moved to mutual funds. However, this will also impact the policyholders' eligibility for FSCS protection if the fund manager defaults.

- In some circumstances, the tax treatment of the mutual funds may differ from that of the unit-linked funds that the policyholders are currently invested in. Even if there are no changes under current tax rules, the relevant tax rules could change in the future.
- When moving policyholders' investments to mutual funds, it is important to ensure that the investment performance that the policyholders will experience is unlikely to be affected. In order to establish whether there could be an adverse effect on policyholders, it is important to compare historical performance and consider whether estimated tracking error (if applicable) is expected to be similar. In addition, it is important to note whether the same portfolio management teams will run the funds, and whether the funds will have the same investment objectives and benchmarks (where appropriate).

## The FCA's Retirement Outcomes Review and its impact on unit-linked firms

### BACKGROUND

In June 2016, the FCA launched its Retirement Outcome Review ("ROR"), which was designed to evaluate the market for retirement income products purchased with defined contribution pension pots. On 28 June 2018, the FCA issued a final report setting out its findings from the ROR along with a consultation paper with a proposed first package of remedies.

Milliman produced a summary of the consultation paper along with our views on the FCA's proposals in July 2018<sup>8</sup>.

<sup>8</sup> [Retirement Outcomes Review: The release of FCA Consultation Paper CP 18/17](#)

<sup>9</sup> [PS19/1: Retirement Outcomes Review: feedback on CP18/17 and our final rules and guidance](#)

<sup>10</sup> [CP19/5: Retirement Outcomes Review: Investment](#)

The consultation period ended on 6 September 2018 and, based on the feedback it received, on 28 January 2019, the FCA published:

- A policy statement setting out final guidance and changes to the Conduct of Business Sourcebook ("COBS") rules for its first package of remedies<sup>9</sup>; and
- A second consultation paper to consult on other proposals that the FCA raised for discussion in its initial consultation paper<sup>10</sup>, including proposed new rules on 'investment pathways'<sup>11</sup>.

### THE FCA'S FIRST PACKAGE OF REMEDIES

Of most interest to unit-linked providers are the FCA's concerns about the lack of competition and innovation in the drawdown market. The FCA has stated that the charging structure for drawdowns is complicated and does not allow consumers to easily compare products.

As part of its first package of remedies, the FCA has therefore introduced changes to address this issue. In particular, for consumers who are entering drawdown, the FCA has amended the Key Features Illustration ("KFI") requirements as follows:

- Including a 'front page summary' of key information;
- Including a first year single charge figure (expressed as a cash amount);
- Including the impact of inflation in all figures presented; and
- Providing a KFI to consumers who are either using an existing contract to move funds into drawdown or taking an income for the first time.

For customers who have drawdown products, the FCA has altered the requirements for annual statements so that they include wording that encourages customers to review their pension decisions and investments, and consider the option of taking regulated advice or seeking guidance. In addition, annual statements must now be provided to consumers who have not yet taken an income.

### THE FCA'S SECOND PACKAGE OF REMEDIES

In its latest consultation paper on the ROR, the FCA is consulting on proposals covering the discussion questions it raised in its initial consultation paper. These all have implications for unit-

[pathways and other proposed changes to our rules and guidance](#)

<sup>11</sup> Investment pathways are ready-made investment solutions, with carefully designed choice options, to help consumers choose investments that broadly meet their objectives.

linked providers, in terms of the options and information that they provide to their drawdown product customers:

- Requiring firms that offer drawdown products directly to consumers (without financial advice) to provide a range of investment pathways. This aims to reduce the number of consumers failing to make an investment decision or selecting investment options that do not meet their needs. Currently, the FCA is proposing that firms offer a different investment pathway to meet each of the following objectives:

1. "I have no plan to touch my money in the next five years"
2. "I plan to use my money to set up a guaranteed income (annuity) within the next five years"
3. "I plan to start taking my money as a long-term income within the next five years"
4. "I plan to take out all my money within the next five years"

It is proposed that larger providers will be required to offer pathway solutions for at least two of the four objectives.

- Preventing drawdown customers investing by default into cash or cash-like assets and therefore ensuring that customers are only invested in cash through a drawdown if this was an active choice. The FCA is also proposing that providers will be required to warn consumers, on an ongoing basis, of the impact of investing in cash long-term.
- Requiring firms to provide consumers with information on actual charges paid including transaction costs (expressed as a cash amount).

The consultation period for the second package of remedies ends on 5 April 2019 and the FCA is expected to publish final rules in a policy statement in July 2019. The FCA has said that it intends to undertake a detailed review of the impact of these proposals one year after implementation.

## Permitted links and illiquid assets classes

The UK government announced in November 2016 that it would set up a Patient Capital Review to improve the availability of long-term 'patient capital'<sup>12</sup> in the UK, and the HM Treasury Patient Capital Pensions Investment Taskforce (the "**Taskforce**") was subsequently set up during 2017 to assess

<sup>12</sup> Patient capital refers to a broad range of illiquid investments, which are intended to produce returns in the long-term.

<sup>13</sup> The permitted links rules specify what types of assets unit-linked insurance contracts can invest in, with the aim of protecting retail investors from making investments that are inappropriate for them.

how to remove barriers to defined contribution investment in patient capital and illiquid assets. The Taskforce identified several areas where an update of the 'permitted links' rules<sup>13</sup> within COBS 21<sup>14</sup> would allow unit-linked investment in a number of patient capital assets, which is considered appropriate given the long-term nature of patient capital and that the majority of unit-linked assets are pension investments where the policyholder is investing for the long term.

In light of its involvement in the Taskforce, the FCA has proposed changes to the permitted links rules in a consultation paper released in December 2018<sup>15</sup>. Whilst no action is required as a result of this consultation, the proposed changes will be of interest to firms looking to expand the range of underlying assets they offer.

The FCA proposes to add additional conditional permitted links whereby insurers can invest in these additional asset categories if they meet conditions which aim to ensure greater investor protection. Proposed changes include:

- Adding a conditional permitted link for 'immovable' structures or installations on any property situated within the UK to the permitted land and property category (COBS 21.3.1R (2) (d))<sup>16</sup>;
- Allowing investment by firms in permitted unlisted securities (COBS 21.3.1R (2) (c)) which are not 'realisable in the short term' provided that liquidity requirements at the level of the investment fund can be met;
- Adding a conditional permitted link for loans secured on immovables, to the permitted loans category (COBS 21.3.1R (2) (e)); and
- An amalgamated overall limit of 50% on illiquid assets held as permitted links or conditional permitted links for firms meeting the investor protection conditions is introduced. This means that, for example, the current 10% limit on assets held in land or property no longer applies for firms meeting the enhanced investor protection conditions. Instead, land and property will be subject to the amalgamated 50% limit for illiquid assets across all permitted links.

The condition under which the above limit can be accessed is that the unit-linked provider must ensure that the investor can exercise their rights under the unit-linked contract within the timeframe in that contract, or within a reasonable timeframe otherwise. These rights include fund switches, withdrawals, transfers and taking of benefits.

<sup>14</sup> <https://www.handbook.fca.org.uk/handbook/COBS/21.pdf>

<sup>15</sup> CP18/40: Consultation on proposed amendment of COBS 21.3 permitted links rules

<sup>16</sup> To facilitate investment in a wider range of permitted infrastructure projects such as rail track, bridges, roads, runways, solar farms etc.

It is also proposed that firms should provide consumers with disclosures during the sales process regarding the level of investment and liquidity risk. The firm should ensure that the investments are appropriate for the investor, and the new permitted links should only be sold to investors with a long-term investment strategy.

The FCA consultation closes on 28 February 2019 and final rules and guidance will be issued during 2019.

## Contract boundaries

### BACKGROUND

In January 2017, Milliman provided a Solvency II update covering the discussion and debate around the application of contract boundaries for unit-linked savings contracts. Later that year we provided a second update on this issue based on the results of the first set of SFCRs.<sup>17</sup>

In our first update, we discussed the guidance that EIOPA had provided (the “**EIOPA Guidance**”)<sup>18</sup> regarding contract boundaries and stated that, for a unit-linked saving contract with no insurance cover or financial guarantees:

- The contract boundary should be the valuation date;
- The calculation of the best estimate liability (“**BEL**”) should include all cashflows expected to be incurred in servicing the obligations that exist at the valuation date (i.e., the unit fund that exists at this date); and
- The cashflow projection should run until the expiry of the obligations.

We also highlighted that a number of firms were using a different interpretation of the Solvency II contract boundary regulations and in particular these firms were:

- Setting an additional contract boundary at the end of the ‘notice period’ to terminate the contract; and
- Not valuing any of the cashflows beyond this additional contract boundary when calculating the BEL, risk margin and Solvency Capital Requirement (“**SCR**”). This includes all cashflows relating to the unit fund in force at the valuation date.

We refer to those firms which do not value any cashflows beyond the end of the notice period as “**Short Projection Period Firms**”.

In our subsequent paper, we discussed the differences between Short Projection Period Firms and those firms that project over a longer projection period in line with the EIOPA Guidance. This

<sup>17</sup> Please contact us if you would like to receive a copy of these papers.

<sup>18</sup> Number 827 on EIOPA’s [Answers to Questions on Guidelines on contract boundaries](#).

different interpretation has a significant impact on the Solvency II balance sheet based on the results of the published SFCRs.

Since the time of writing of these initial papers, the second set of SFCRs has been published.<sup>19</sup> The PRA has also published a letter (the “**PRA Letter**”) addressed to the Chief Actuaries of UK insurance companies on 13 July 2018, which included the PRA’s thoughts on interpreting the EIOPA Guidance. The PRA states that the Short Projection Period Method is an acceptable simplification, subject to the proportionality requirements of the Delegated Regulation.

### LATEST PUBLISHED RESULTS

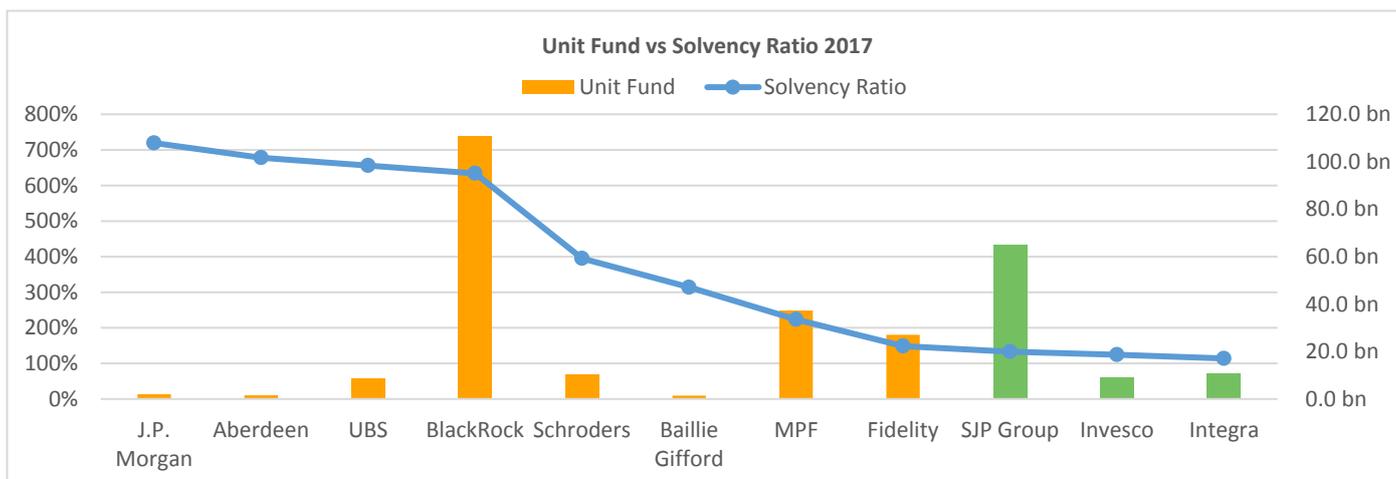
The second set of SFCRs includes details of the methodology currently used to determine the Solvency II balance sheet.

Figure 1 below shows the size of the unit fund alongside the solvency coverage ratio (as at year-end 2017) for the following firms:

- J.P. Morgan Life Limited;
- Aberdeen Asset Management Life and Pensions Limited;
- UBS Asset Management Life Limited;
- BlackRock Life Limited;
- Schroder Pension Management Limited;
- Baillie Gifford;
- Managed Pension Funds;
- FIL Life Insurance Limited;
- St. James’s Place Group;
- Invesco Pensions Limited; and
- IntegraLife UK.

<sup>19</sup> At the time of writing, Milliman is drafting a summary of the UK and European life insurance markets, based on the results of this latest set of SFCRs. Please contact us if you would like to receive a copy of this summary.

Figure 1: Unit fund vs solvency ratio



Short Projection Period Firms are shown in orange and the firms following the EIOPA Guidance are shown in green. Figure 1 shows that the solvency coverage ratios are in general higher for the Short Projection Period Firms. This is consistent with the results seen at year-end 2016.

The projection periods used for the calculation of the BEL are largely unchanged from those seen in the previous update. In particular, none of the Short Projection Period Firms have switched to using the longer projection period or vice versa.

Although both methods have been deemed acceptable by the PRA, the PRA Letter suggests that any change from one method to the other would have to be justified. This could prove challenging for firms and we are currently not aware of anyone trying to do so.

The SFCRs for the Short Projection Period Firms provide some of the required justification for the choice of the shorter projection period. The reasons given include:

- The notice period reflects allowance for a possible future decision to reconsider the long-term viability of the firm as part of the wider asset management group in the event of a large fall in funds under management (“FUM”);
- The ‘large and disproportionate’ cost of developing a more sophisticated model to capture the longer projection period of the EIOPA Guidance.

In the future firms should follow the guidance in the PRA Letter and ensure that they assess whether they meet the proportionality requirements when using the contract boundary simplification. The Chief Actuary is responsible for ensuring that any error introduced by this simplification is evaluated both quantitatively and qualitatively.

Figure 2 below shows the largest component of the SCR for 2017 for each of the 11 companies considered and shows the

Short Projection Period Firms in orange and the firms following the EIOPA Guidance in green.

Figure 2 clearly shows that the methodology chosen with respect to contract boundaries impacts the risk exposure that the Standard Formula SCR shows as the most severe.

Figure 2: Largest components of the SCR by firm

| COMPANY         | SOLVENCY RATIO | LARGEST SCR RISK MODULE |
|-----------------|----------------|-------------------------|
| J.P. MORGAN     | 719%           | MARKET                  |
| ABERDEEN        | 678%           | OPERATIONAL             |
| UBS             | 656%           | LIFE UNDERWRITING       |
| BLACKROCK       | 634%           | OPERATIONAL             |
| SCHRODERS       | 395%           | OPERATIONAL             |
| BAILLIE GIFFORD | 314%           | OPERATIONAL             |
| MPF             | 224%           | OPERATIONAL             |
| FIDELITY        | 149%           | COUNTERPARTY DEFAULT    |
| SJP GROUP       | 133%           | MARKET                  |
| INVESCO         | 124%           | LIFE UNDERWRITING       |
| INTEGRA         | 114%           | LIFE UNDERWRITING       |

As can be seen above, the Short Projection Period Firms often have operational risk as the largest component of the SCR, whilst the remaining firms in this category see different risk modules for each as the largest.

J.P. Morgan’s large exposure to market risk is due mainly to ‘seed capital’ i.e. a large investment of shareholder funds into one of the firm’s own unit-linked funds.

The firms that use a longer projection period and value the cashflows from the existing business (as at the valuation date) tend to have market and life underwriting risks as the largest components of their SCR rather than operational risk. This is similar to the results outlined in our previous update.

Milliman does not certify the information in this paper, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.

## The effect of IFRS 17 on unit-linked accounting

IFRS 17 is the new insurance contracts standard with an effective date of 1 January 2022. This new standard will bring widespread change to the accounting treatment of insurance contracts. IFRS 17 describes three distinct measurement models that are to be applied for different types of insurance contracts:

- The Variable Fee Approach (“VFA”);
- The General Model; and
- The Premium Allocation Approach.

For insurance contracts that have ‘direct participation features’ (i.e. the policyholder is entitled to a substantial proportion of the returns from a specified pool of underlying items), the VFA is applied. The purpose of the measurement approach is to determine the insurer’s share of the underlying items (in the case of a unit-linked contract, a variable fee or AMC, net of any expenses) on a market consistent basis. This is termed the Contractual Service Margin (“CSM”), which is then realised in profit or loss as the insurance and investment services are provided to the policyholder.

This approach contrasts with existing accounting approaches in that the CSM is determined such that there is no realised profit on Day 1 of the contract. If an insurer uses Solvency II as the statutory reserves for accounting purposes, the presence of a best estimate negative non-unit reserve would mean that the expected profits on the unit-linked business would all be realised at recognition, and then the variation in experience relative to that expected would lead to additional profits or losses in subsequent periods. However, if an insurer holds the surrender value (commonly the unit value) of the unit-linked contracts as the statutory reserve, this is likely to lead to a similar profit recognition pattern to that under IFRS 17, as the absence of a

negative non-unit reserve has the effect of eliminating a Day 1 gain.

One important point on the subject of unit-linked business under IFRS 17 is that unit-linked savings contracts that do not carry any insurance guarantees to policyholders are not in scope of IFRS 17, as they are not considered to be insurance contracts. Instead, they are accounted for under IFRS 9 or IFRS 15.

## How Milliman can help

Milliman has a wide range of experience of working with unit-linked business. Our consultants and principals hold a number of Chief Actuary roles and have worked on a range of transactions and restructuring projects across the sector. In particular, we have supported such firms in the following areas:

- The calculation of the Pillar 1 Solvency II Balance Sheet including ad hoc queries covering regulatory interpretations;
- The production of forward-looking projections;
- The completion of the Solvency II QRTs;
- Contribution to and review of the SFCR and RSR;
- Independent Expert assignments for Part VII transfers;
- The production of fund illustrations for fund fact sheets;
- Independent reviews of Key Information Documents for Packaged Retail Insurance-Based Investment Products (“PRIIPs”);
- An analysis of how firms which operate ‘mirror’ funds provide the outcomes consumers expect; and
- Other areas required as part of the Actuarial Function and Chief Actuary roles.

If you have any questions or comments on this paper, or on any other issues affecting unit-linked insurance business, please contact any of the consultants below or your usual Milliman consultant.



Milliman is among the world’s largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

[uk.milliman.com](http://uk.milliman.com)

### CONTACT

#### United Kingdom

Claire Booth

[claire.booth@milliman.com](mailto:claire.booth@milliman.com)

Thomas Bulpitt

[thomas.bulpitt@milliman.com](mailto:thomas.bulpitt@milliman.com)

Neil Christy

[neil.christy@milliman.com](mailto:neil.christy@milliman.com)

Emma Hutchinson

[emma.hutchinson@milliman.com](mailto:emma.hutchinson@milliman.com)

Marie-Lise Tassoni

[marie-lise.tassoni@milliman.com](mailto:marie-lise.tassoni@milliman.com)

Milliman does not certify the information in this paper, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.